DOW THEORY LETTERS INC.

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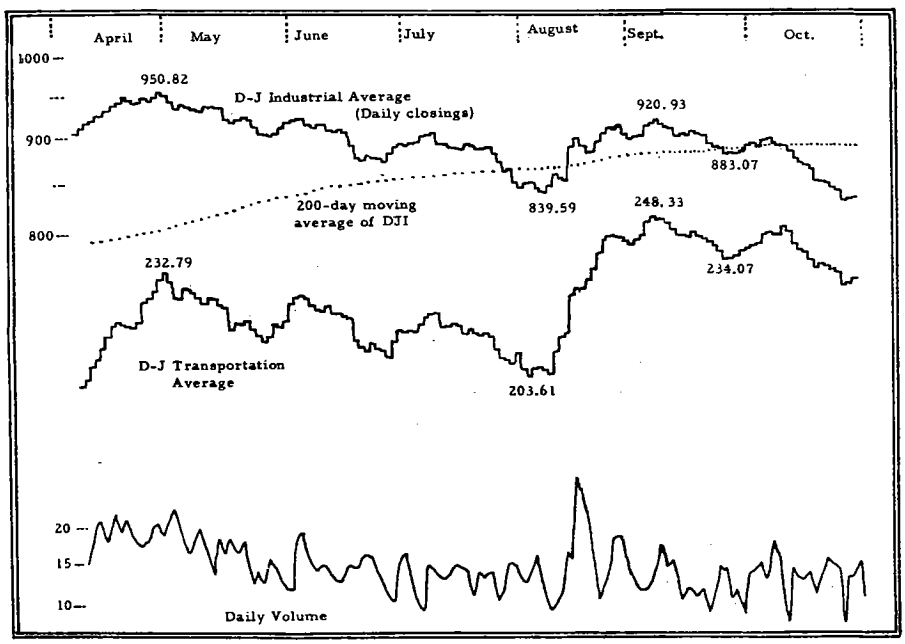
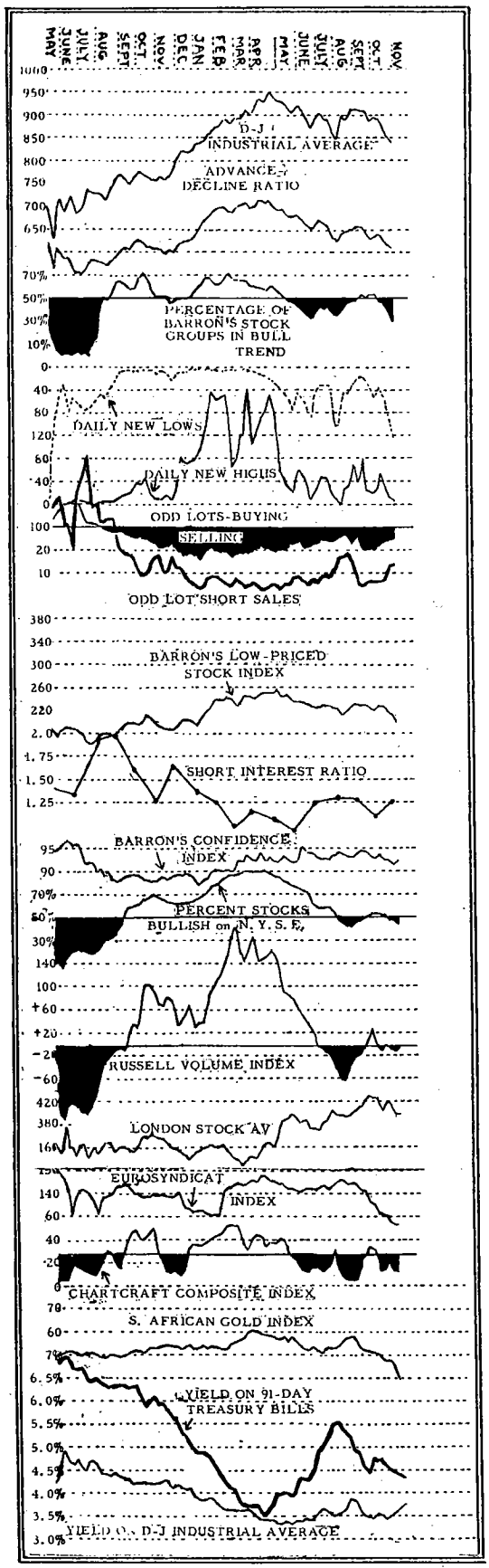
THE PICTURE: The costly and, to many, "shocking" action of the past few months can hardly come as a surprise to readers of these reports. I have warned in Letter after Letter of the dangers inherent in the 1971 situation, this despite the fact that investment advisory sentiment hit new heights of bullishness as the year progressed.

I explained that historically it is an ominous sign when the Dow Industrials record a peak in April, then fail to better that peak by the fall of the year. The examples of the years 1930, 1940 and 1956 were given. This "calendar" thesis was first put forth in Letter 501 (July 28) and again emphasized in Letter 507 (Sept. 22). I further warned that when this calendar phenomenon occurs in primary bear market years (such as 1930 or 1940) the implications are more dangerous than when the phenomenon occurs during a primary bull market year such as 1956. The current year, 1971, I might add, falls within the framework of a continuing primary bear market, a bear market which began in February, 1966.

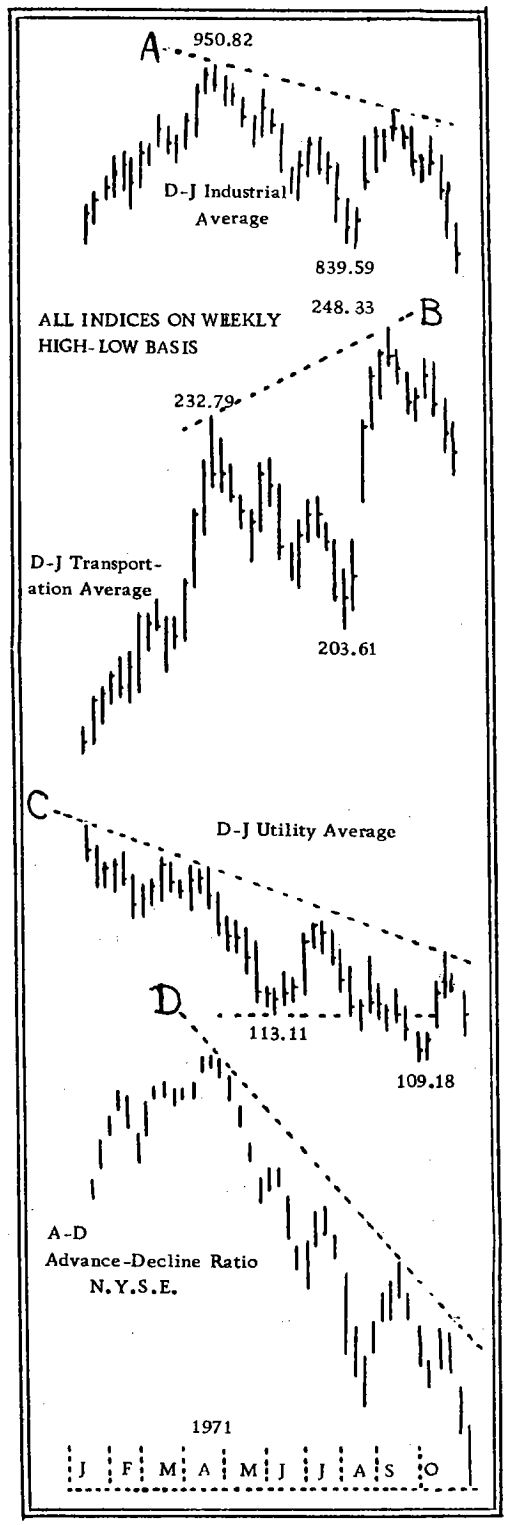
In study after study throughout this year I pointed to the deteriorating technical situation, from the most-active stock index to the Dow short interest ratio, from the group high-low chart to the percentage of stocks bullish. In Letter 507 (Sept. 22) I introduced the chart seen on page 2 of this report. This chart dramatized the divergences of the four leading market indicators, the Industrials, Transports, Utilities and the advance-decline ratio. Letter 507 (page 1) noted, "Such major non-confirmations (major in that they are spread out over a period of months, rather than a few days or weeks) are always indications of grave potential danger."

So much for past warnings. If any of my subscribers have lost money in the 1971 debacle, I am sorry to hear of it but I must say that my conscience is clear. On page 2 I again include the four-indicator chart, and here we see that the resolution of the non-confirmation and divergence hodge-podge is (as I suggested it would be) coming on the downside.





On October 20 the advance-decline ratio broke below its August bottom, to record a new low for the year. Five trading days later, on October 27, the Dow Industrials confirmed by violating their own August 10 low of 839.59. With the recent September low in the Utility Average and the October lows in the Industrial Average and the advance-decline ratio, the picture becomes somewhat different than that recently described. Up to now, we were talking about upside non-confirmations; the fact that the Industrials would not confirm the new recovery high in the Transports, and the fact that the A-D ratio would not confirm the Industrial Average's bettering of its July peak. All of this implied a coming major decline.



Now the situation is reversed. The Industrial Average has dropped below its August low, the Utility Average has recently struck a low for the year, the A-D ratio has fallen to a low for the year. It now remains for the Transportation Average to confirm on the downside by breaking its August 3 low of 203.61. Note on the page 2 chart that we have the trendlines A, C and D, all tracing various series of declining tops and bottoms. In other words, A, C and D are all bearish trendlines. Against this we have the Transport trendline B, showing a pattern of ascending tops.

It is a cornerstone of Dow Theory that the two Averages, Industrials and Transports, must confirm each other in all movements through preceding significant points. My own interpretation is that in time, the Transportation Average will confirm on the downside by violating its August low. This could happen in a week or a month or a few months. Until then, there remains the constant possibility of a rally (since Transports have resisted on the downside), but I would say that any such rally would be entirely transitory. For coming, as it must, within the framework of a primary bear market, any rally must only be considered as a correction of an oversold condition and not as representing any fundamental change in the primary trend.

Remember, we are still in the long, costly second phase of this bear market. This is the phase when stocks go down as they reflect deteriorating social, political and economic conditions in the nation. The second phase of a bear market is traditionally the deceptive one, and the current second phase (the second phase of this bear market began in October, 1966) has certainly been one of the most deceptive in Wall Street annals.

I believe that the upward (or counter-trend) portion of the second phase is now over, and the market is about to fall like Goliath with the stone embedded deep in his forehead. Before this second phase is over, the Industrials and Transports will have smashed through their 1970 lows of 631.16 and 116.69 respectively! Following such a major and devastating bear movement, I would expect the Dow to sink to some extraordinary oversold technical condition (below 631), then rally (probably on greatly reduced volume) as a new secondary upward correction begins. Ultimately we will go into the third and final phase of this bear market.

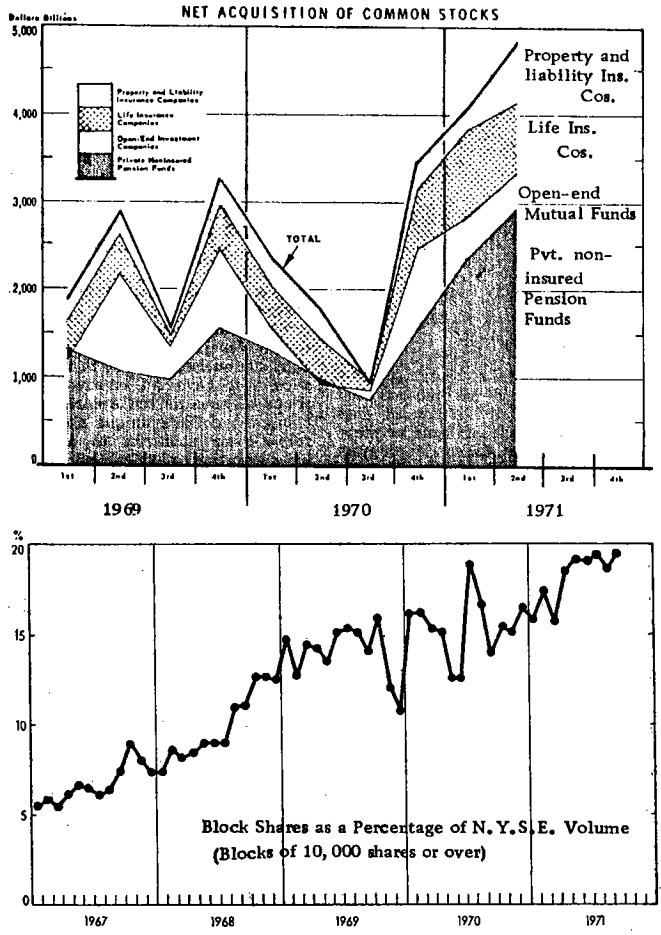
I have been asked where I think the third phase of this bear market could end. If I had to guess, I would say in the 300-400 range on the Dow. Remember, the first major decline in this bear market occurred in 1966 (995 to 744 on the Dow), lopping 251 points off the Industrial Average. The second major decline occurred during 1969-70 (985-631), slicing 354 points off the Industrial Average. Following each of those major declines, the Government threw its full powers against the forces of correction, against the primary bear forces.

Now, I feel that the Government has literally exhausted its manipulatory arsenal and the market is heading down again. It is heading down with this nation in far worse condition than it was during 1966 or in 1969-70. Therefore I would guess that from the last major peak (the 950 peak of 1971) the Dow could lose as much as the 1966 and 1969-70 declines together before the bear market is through correcting all that it has to correct.

The 1966 and 1969-70 declines taken together amounts to 605 points. Subtracting that amount from the 1971 recovery peak of 950 we get a figure of 345. That would be my guess as to where the Dow will stop before this bear market breathes its last and a new primary bull market is ready to start up from the ashes.

THE TALE UNFOLDS: I have stated in previous Letters that the public is now leaving the market. The public, in fact, is leaving the market in droves, and the Holt Investment Advisory has recently estimated that the even and odd-lot public taken together are exiting at the rate of 10 billion dollars per year.

Now in order to take up this massive flood of stock for sale, we must depend on the mutual funds, the pension funds and the insurance companies. The accompanying two charts tell part of this story. The lower chart shows big blocks (10,000 shares or more) as a percentage of total N.Y.S.E. volume. Currently the big blocks are taking up a record 19% of all Exchange volume. No doubt about it, the institutions are in there doing business like there is no tomorrow.



But the problem is that with the public selling like mad, the institutions (who are now absolutely loaded with stock) better be buying like mad. The question — can they? The upper chart shows the net acquisitions of common stocks by the four major categories of institutions. Note that by far the biggest buyers are the pension funds. The pension funds bought a record $7.6 billion of stocks in the 12 months ending June 12. In fact, pension funds invested a whopping 80% of their new money in common stocks during the year ending June 30. The indications are that the pension funds are about "bought up".

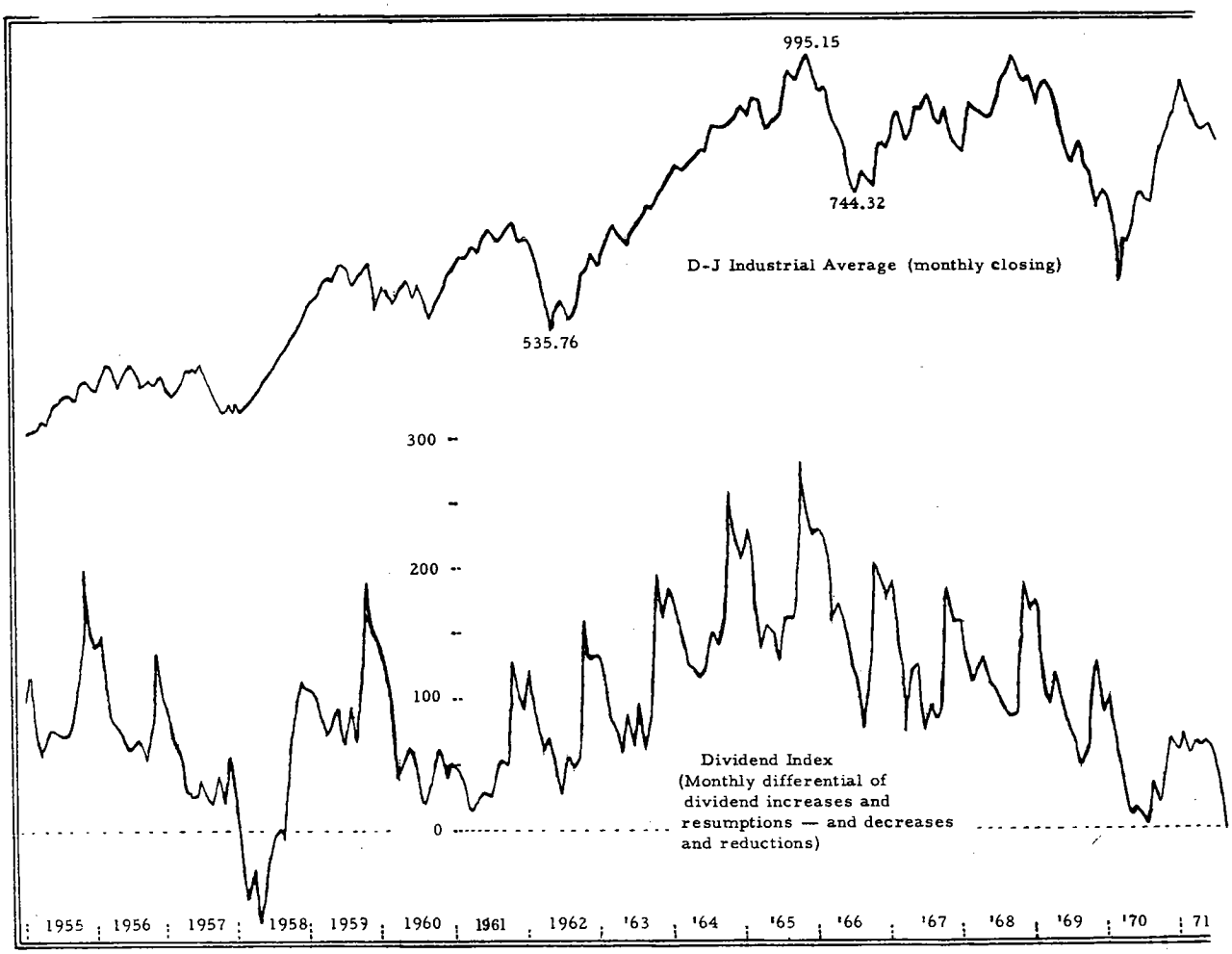
Life insurance companies put $2.6 billion in common stocks during the 12 months ending June 12, and this is far above the 1970 figure of $1.8 billion. It is thought that the insurance companies are now near their legal limit of 10% of life insurance assets in common stocks. This suggests that the insurance companies will not be much of a buying force in this market.

So last we have the mutual funds. I mentioned in the last Letter that the funds suffered net redemptions over purchases in four of the last five months with a record September loss of $166 million in redemptions over sales. But the frightening fact is that the funds' cash position for the month of September dropped from a low 5.6% to a very low 4.7%. For all intents and purposes, the funds haven't got much cash to invest at this point, even if they wanted to. And if anything like the current trend in redemptions over purchases continues, the mutual funds are going to act as a depressant on the stock market; they are going to be a minus factor instead of the plus factor they have been for years. The sad fact is that the funds are now being forced to sell stocks.

I might also mention the mountain of new offerings of common stocks coming to market, a fantastic total of $8.2 billion in the year ending July 31, 1971! All of this new stock has to be absorbed by Wall Street in a market which finds the public heading for the exits and the institutions up to their ears in common stock.

In closing I might mention a fact which the average reader will find hard to believe. At the end of 1971 (most recent figures), despite a long period of unloading, individuals held $700 billion or 81% of all common stocks (individuals consist of not only small holders, but estates, family holdings and trusts). Thus, if "individuals" continue to unload their shares, the amounts to be unloaded will far surpass any capabilities the institutions have to absorb those shares, let alone absorb new issues and bonds.

EBBING TIDE: Charles H. Dow stressed that value ultimately depended on the return on the investment. The measure of the return on investment, is yield (which in the vast majority of cases is the dividend).



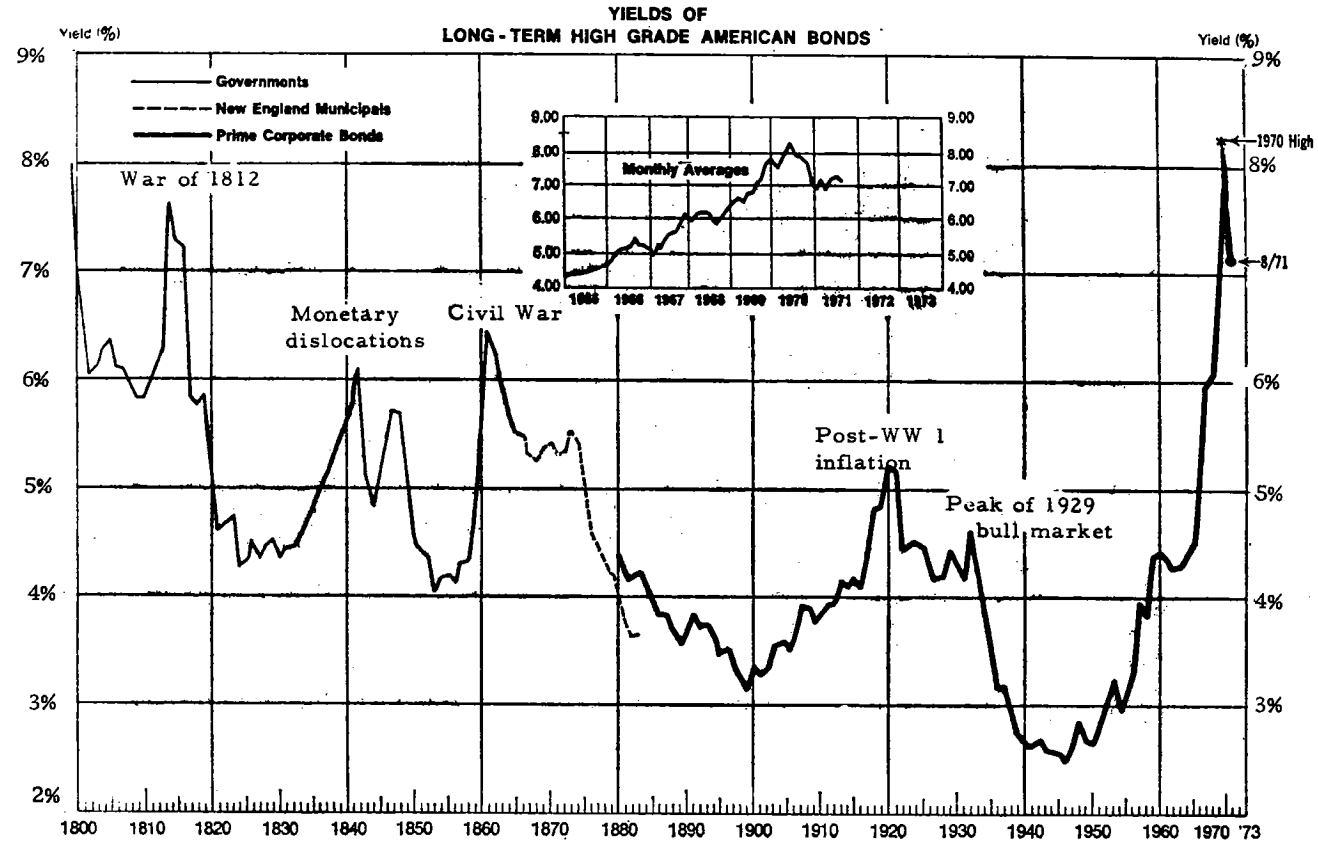
Over the past few years I have periodically included a chart of the trend of dividends, and as far as I know this is a feature which no other investment service offers. I consider the trend of dividend increases or decreases as a fundamental characteristic of a primary bull or bear market. During a bull market, the trend of dividends is generally towards resumptions and increases. During a primary bear market, the trend of dividends is generally towards reductions and omissions. Obviously, such trends determine values over the long run, and that is what we are interested in.

The accompanying chart traces the pluralities of dividend resumptions and increases over decreases and omissions (or vice versa if there are more decreases and omissions than increases and resumptions). Note that from the violent recession of 1958, the trend has been upwards on the graph until the late-1965 period. In November, 1965, the differential in favor of increases and resumptions was 282. Three months later, in February, 1966, the bull market hits its peak with the Dow Industrials at 995.15.

Then the trend of dividends started down, and by August, 1970, we saw a low of plus 2 on the chart. At the time I wrote that within a year I expected the differential to drop below zero, to the minus side of the ledger. The September figures are now out (the figures are released by Standard & Poor after tabulating thousands of corporate announcements), and for the first time since September, 1958, the differential is on the minus side at minus 2.

Now of course the drop can be blamed on the Nixon freeze, but personally I could not care less what the reason for the drop is. The fact is that stocks are less attractive when the long-term trend of dividends are down, regardless of whether the trend is due to a war, a price freeze, a world recession or anything else. In September, 1970, there were 53 dividend increases and 13 dividend resumptions. This September dividend increases dropped over 50% to 24 and resumptions dropped way off to only 3. Now those drops could be totally due to the freeze (but I rather doubt it), and I would prefer to take the chart at face value without "explaining it". On this basis, we have seen the first minus figure in 13 years, and I feel that is ominous. It is a sign of the unsheathing of the claws of the bear.

MONEY RATES: I am including this fascinating long-term chart (page 5) of high-grade bond yields going back to 1800. The peaks and valleys on the chart correspond with the various crises in the history of the United States. For instance, the first peak in interest rates was brought on by the War of 1812. This was an unpopular war (shades of Vietnam?), and many of the individual states refused to provide financing for the Government's war efforts. As a result, new Government bond issues collapsed in price, bringing on yields of almost 8% in the Government sector.



The interest rate peak in the early 1840's resulted from a period of wild speculation during the 1830's, ending in the collapse of 1837 and a depression. Treasury surpluses gave way to deficits and rising interest rates during the early 1840's.

The interest peak of 1861 was brought on by the Civil War, with 1861 representing the period of crisis regarding how the war was to be financed. The later decline in interest rates occurred as two post-war depressions squeezed the excesses out of the war-swollen debt markets.

The Post World War I inflation took interest rates to a peak in 1920, and this was followed by a surprisingly severe depression during 1921 and 1922. Then came the great bull market of the 1920's, which took interest rates to their secondary 1929 peak. All during the 1920's, however, it is notable that the Government was actively reducing the national debt, so that by 1929 the debt was below that of the mid-1920's. The excesses were again squeezed out following the 1929 interest rate peak, and interest rates fell away in the wake of America's worst depression. During World War II bonds were "stabilized" by the Government, and this is the reason that interest rates held very low during the war.

The final low of interest rates was touched in 1946. From there, rates headed up as the U.S. embarked on a massive program of spending, debt-building and inflation. The bond market headed into one of its greatest and most persistent bear markets. By 1970, under the onus of Vietnam, interest rates of high-grade bonds moved over 8%.

All of which brings us to the present and to the burning question — what will cause the interest rate structure to decline as it always has following previous periods of excess (usually brought on by war and deficit spending)? My own guess is that a severe depression with accompanying liquidation, lowered spending and collapsing demand will bring interest rates down to more normal levels over the next few years. Meanwhile, I believe it is possible for rates to embark on one more upward run, perhaps as a final liquidity crisis overtakes the U.S.

But as far as we as market students and investors are concerned, it does not matter whether we have one more liquidity crisis or whether we go into a long period of debt reduction and expense cutting. My conclusion is that the interest rate chart shows the present to be a period of great excess, and such periods have always been followed by periods of liquidation and contraction. This, in my opinion, is what we face as the bear market story unfolds during the several years ahead.

NOTES AND THOUGHTS: I received a letter today from friend Eliot Janeway asking why I don't talk about the "divergence" in the economy as well as the divergence in the stock market. He notes that despite record auto production, all auto supply industries such as steel, aluminum and copper are in major slides. Same picture in housing with American Standard in distress during housing boom. "You can quote me as saying," writes Janeway, "that auto production and housing starts are peaking now and will be in a major slump by Spring."

From the current Schaefer's Dow Theory Trader (910 E. 38th St., Indianapolis, Ind. 46205) comes an interesting comparison of 1971 with 1929. Schaefer notes that bear raids in '29 had a large hand in driving the market down, but short selling can now be executed on "up-ticks" only. "What will drive the market down this time," says Schaefer "is 'mass disillusionment' — the crowd doesn't know what to believe anymore." I thoroughly agree, and want to add that the one "ingredient" no economist can mix into his econometric model is crowd psychology. And the psychology of the public, I believe, is going to be the big fooler for the remainder of this bear market.

Treasury Secretary Connally is currently considered almost certain to replace Agnew on the 1972 Republican ticket. But let the market fall apart and I feel that Mr. Connally's chances will evaporate. So, for that matter, will the whole Republican ball game. For that reason, I don't see Mr. Connally as the next Republican Vice-Presidential candidate, and I don't see the Republicans winning the '72 elections.

On this page we have the gold-silver-world markets chart, and the chart has changed little since the last mailing. However, the fact is that there exists a serious divergence between the trend of the price of gold and the gold shares. I continue to recommend holding gold shares for the very long pull. It is becoming increasingly obvious that there may be an early token rise in the price of gold of say 10% to 15%. Since the free market price of gold is already there, many people believe that the golds have already discounted the best that can be seen ahead, and they are selling their golds on the basis of a disappointing 10-15% boost in the gold price.

But the gold-share sellers are not banking on a world depression. I believe that when that arrives around late-1972 or 1973, gold will receive its real price rise, perhaps to $70 or $105 per ounce or even more. The world will be desperate to get out of the depression and drastic moves will be required. A huge advance in the gold price will be one of those needed moves. Until then, patience will be needed.

STOCKS: General Motors is the world's largest manufacturing enterprise, and what it does affects the markets and the economy of the entire U.S. This M.C. Horsey monthly chart covers the movements of the GM over the last 17 years. Note that GM topped out at 113 in 1965, and that a massive "triple-top" line of resistance has formed around the 90 area. The high for 1971 was hit in April at 91 and even the Nixon phase 2 announcement could not take GM back over its April peak. Now with the stock under 80 (despite record auto production), it seems to me that GM is heading lower (under the cover of good news) following a period of massive distribution. If GM hits 74 for a new 1971 low, I would say it would represent a very ominous sign indeed for GM, the auto industry and for the nation as a whole during the next few years.